DOW THEORY LETTERS INC.

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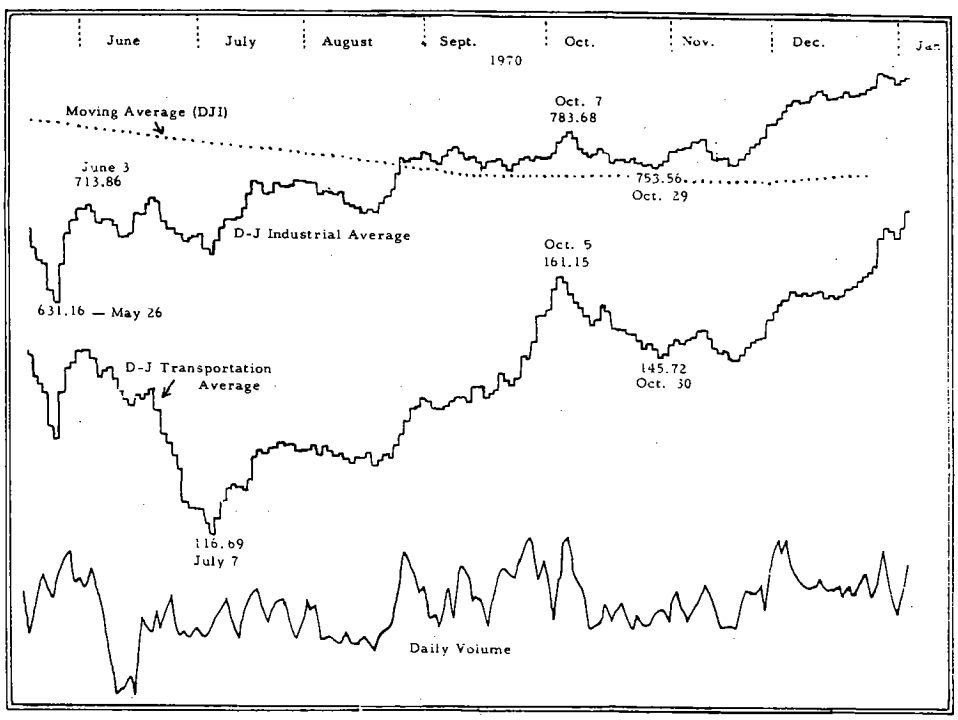
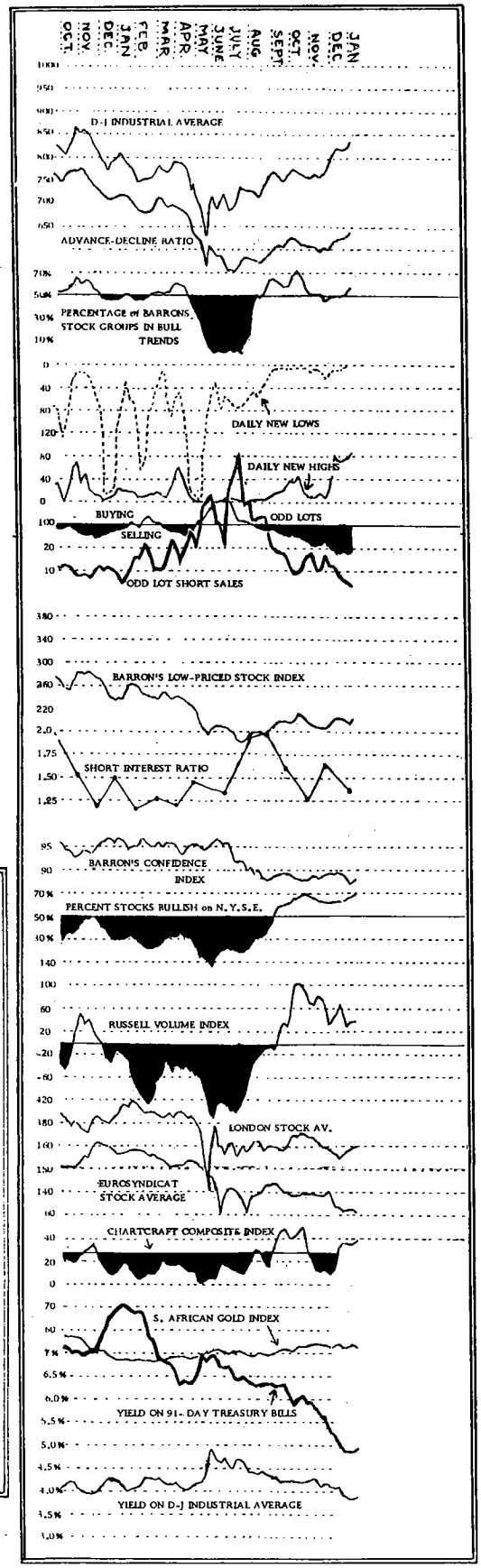
THE PICTURE: In a television address on January 4, President Nixon announced that 1971 is to be "a good year" for business, and that 1972 will be "a very good year". Optimists can now have the comfort of knowing that they are proceding according to the very latest Administration "game plan". So here comes 1971, and there aren't many bears left. In fact, you can count the bears on the fingers of one hand: Myself, Eliot Janeway, Irving Weiss of Capital Advisors, E. George Schaefer, the Dow Theorist from Indianapolis, and C.V. Myers of Canada and Switzerland. The rest of the professional "voices" and investment services are outright bullish, and they're predicting everything from a major advance to 1000 to an explosion to 1400 on the Dow. I must admit that I haven't heard any forecasts above the 1400 mark, but after the 1969-70 debacle most of the sooth-sayers have learned to hedge their bets and check their enthusiasm.

Actually, a seven month rally, taking the Dow from its May low of 631 to well above the 800 mark, has served to turn the investment fraternity bullish, and there is nothing new in that. From February, 1966, to the present, every rally of any import has accomplished the same trick, and there is no reason why this one should be any different (particularly in view of its extent). In the January 4, issue of Barron's (page 13) there appears an article entitled "Dow Theory Signal; It's a Bull Market". The writer (Robert W. Ross) bases his "bull market" conclusions entirely on the configurations of the Industrial and Rail Averages, while leaving out all considerations of phase, yield, value, speculative sentiment and whether the May, 1970, lows provided any indications of the termination of a primary bear market. I have always warned against this simplistic approach to Dow's Theory, and while I have no doubt of Mr. Ross' sincerity, I do not think his mechanical interpretation of the Dow Theory will hold water. Nor do I think it will prove to be correct.





I am not going to repeat all the arguments against "the new bull market" thesis. Suffice it to say that at the May, 1970, lows, nothing had been corrected (except the price of the Averages themselves), and none of the tell-tale indications of the final phase of a bear market were present. At the May lows the yield on the Dow was only 4.7%, while the yield on the D-J 40-Bonds was 8.5%, average daily volume was still in the 8 million shares per day class, sentiment was poor but not despondent, interest in Wall Street was still running high, and not a single day of panic-decline had accompanied the entire descent from the 1969 highs. None of these manifestations bespoke of the end of a primary bear market.

The correction (upwards) came rapidly, without the usual dull, sideways movement associated with a bear market's end. The advance was technical in nature, a response to the extraordinary compression on the downside and the greatest breadth (A-D ratio) collapse in history. The rationale for the recovery was provided by the Federal Reserve Board's move towards monetary flooding, plus promises that Mr. Nixon could not allow unemployment to stay high nor the economy to languish as the 1972 election period neared. Meanwhile, the "fight" (if there ever was one) against inflation was abandoned. I remain unimpressed by the market action and psychology, and I am singularly unimpressed as to the reasons for the rise. As far as I am concerned, none of the maladjustments and follies of the preceding bull market have been corrected. Before this bear market is over I am convinced that the corrections will be all too obvious.

As to the near-term, a decline of 2.40 points in the Dow on December 31 was followed up by a further decline of 8.35 points on January 4, first trading day of the new year. The first decline, following an extended advance, seldom tells us anything. The test of a market's strength or weakness is gauged by what the Averages do following the termination of the initial decline.

The market points on the downside (January 4) were 830.78 for Industrials, 169.70 for the Transports. On the upside are the rally peaks (December 29) of 842.00 for Industrials, 172.08 for Transports. Following the two-day sell off to the January 4 lows, the market rallied smartly, and the upside points are therefore the ones to watch. A bettering of 842.00 and 172.08 would signal a further extension of the advance, and the signal would be heightened by an increase in volume. However, if one or both Averages fail to better the highs and the market again turns down, the lows of 830.78 and 169.70 will be the important near-term levels to watch.

BIG PICTURE: Here is my own chart (page 3) of the three Averages and their travels over the last five years. The chart traces the entire bear market on a weekly high-low basis, from 1966 to the present. Since the three Averages are all drawn to semi-logarithmic (ratio) scale, their action can be properly compared. For instance, a 10% move on the Industrial Average will cover exactly the same distance on the chart as a 10% move in the Transport or Utility Averages.

It is immediately apparent that between early 1966 and the May lows of 1970, the Transport Average showed the greatest losses, almost twice that of the Industrial Average. It is therefore not surprising that percentagewise, the Transports have gained more than Industrials on the current correction.

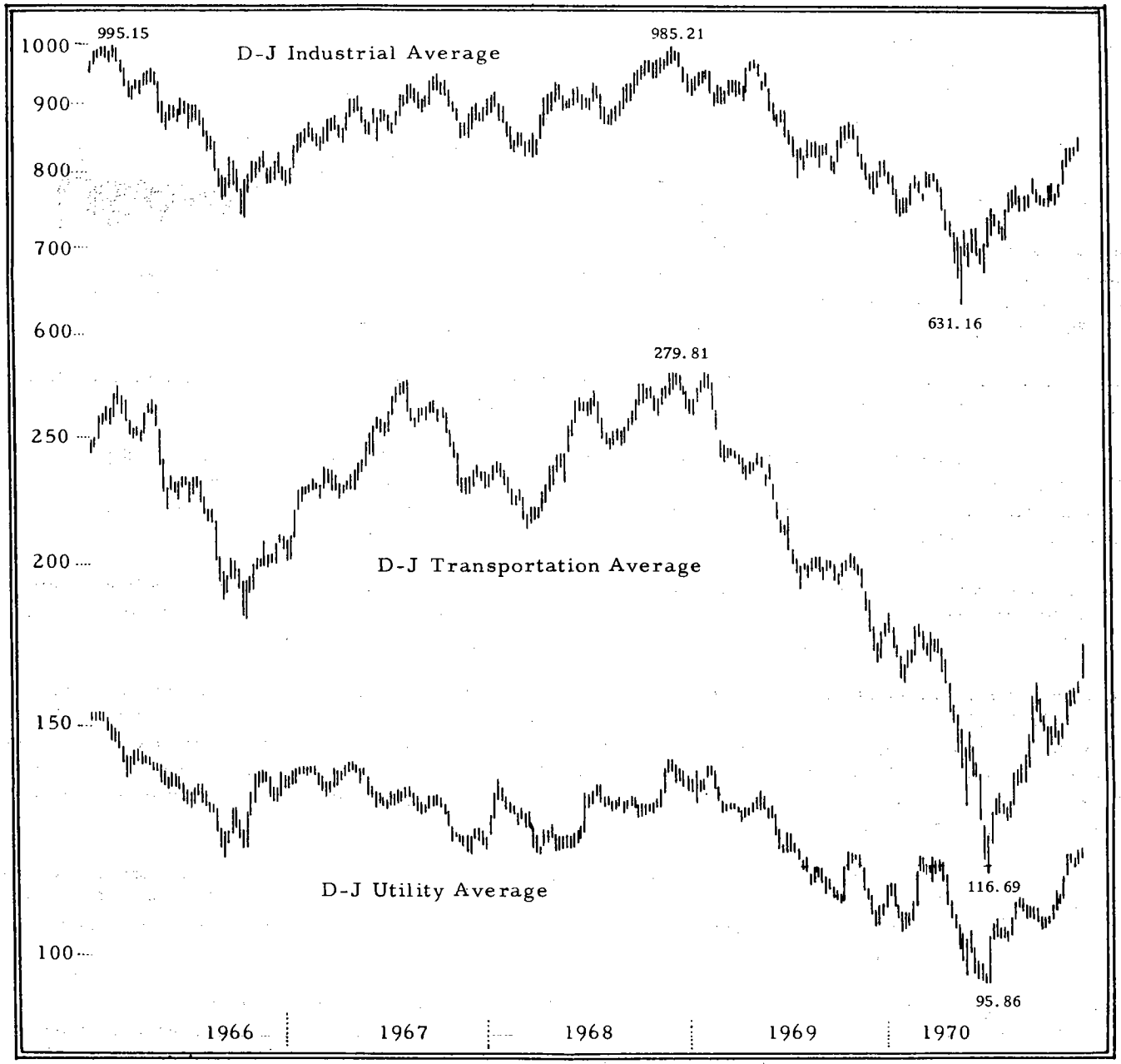
Surprisingly, if you take a pair of dividers and measure the total loss of the Utility Average from 1966 to the 1970 low, you will note that Utilities too lost more in percentages than the Dow. But on the recovery Utilities have failed to match the percentage gains of either the Transports or the Industrials. Therefore, although most investors are unaware of it, the Utilities must go down as having shown a worse performance than Industrials on the downside and a poorer recovery than Industrials on the upside. Utilities proved considerably better than Transports on the downside, but they failed to match Transports in percentage of recovery.

To me the picture runs like this: Investors are increasingly frightened by inflation. Transports, with their very poor earnings, did not find favor with investors, nor did Utilities with their regulated rates and huge debt loads. Industrials remained the favored vehicles for "beating inflation", despite poor earnings on the part of many stocks during 1969 to date.

The segment of the market which investors have turned to for inflation-protection during the last five years is the blue-chip industrial segment (most lesser quality common stocks are still far below their bull market highs). Therefore, here is my prediction for the bear market years coming up. I believe we will see a collapse in confidence in the earning power of the blue-chip industrial segment of the market. This is the sector which has fared better than any other (including bonds) as inflation runs rampant and as earnings of corporations across the land suffer from eroding sales, rocketing debt and high interest rates.

Psychologically, to the average investor it "isn't a bear market until the Dow Industrials are smashed to frighteningly low levels". Before this primary bear market is over, I believe that we are going to see exactly that.

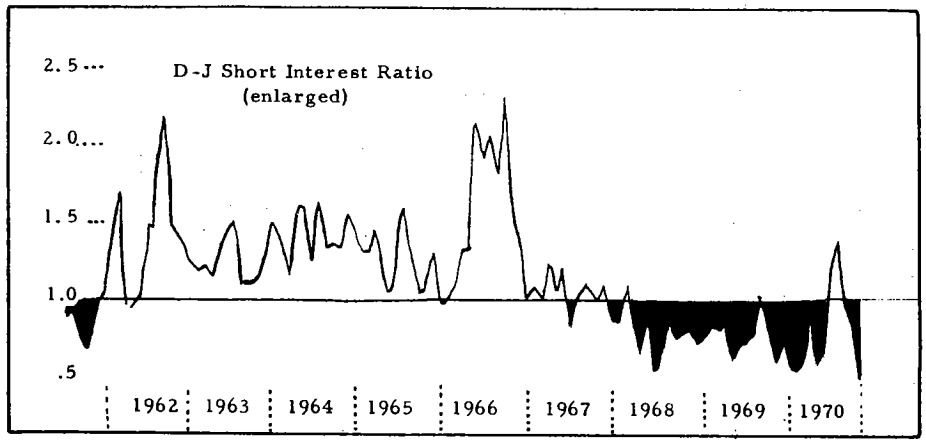
DOW SHORT INTEREST RATIO: One of the indicators (page 4) which we have watched throughout this bear market is the Dow short interest ratio (DSIR), developed by Bill Gordon of New York a few years ago. This is the ratio of the actual short interest in the 30 Dow stocks and the volume in those stocks over each one-month reporting period.



I have, on occasion, presented the entire history of the DSIR going back to 1931. The accompanying chart covers the ratio from 1962 to the present. I feel it is well worth studying the current picture and how this picture differs from previous areas. First, let us take two previous major market declines, those of 1962 and 1966. Note that as year-end 1961 came in, the DSIR was well below the critical 1.0 zone, a clear warning sign. The stock market started breaking as 1962 entered, and as the market continued its major break into June of that year, the DSIR rose, showing that the short position in the Dow was building up in relation to volume. By October, 1962, the DSIR had risen to a very high 2.19, an indication of much stronger markets to come.

The years following, 1963 through 1965 produced strong markets, and all during that time the DSIR hold above 1.0. Finally, in January, 1966, the DSIR gave its first warning, dipping under 1.0 to .93. In February it gave a reading of .99. Then as the stock market broke violently, the DSIR again shot upward, indicating a build up of shorts in the Dow stocks in relation to volume. By August, 1966, the DSIR gave a reading of 2.05, and by October, 1966, the first leg of the bear market ended, to be followed by a major upward correction.

A DSIR reading of .82 in July, 1967, was followed by a sharp market dip into 1968, but the stock market turned up in the first quarter of 1968 and continued to a high in December. However, during 1968 the DSIR plunged deep into under 1.0 territory, and I wrote repeatedly during 1968 that the danger flags were flying.



The danger surfaced as 1969 came in. The year 1969 produced a collapsing market, and the horrendous decline continued into mid-1970. The bottom for the Dow came in May, 1970, at 631. But surprisingly, the build-up in the DSIR was short-lived and entirely sub-standard.

From a .65 reading in June, 1970, the DSIR jumped to 1.19 in July, then a peak of 1.40 in August. That was the sum total of the DSIR build-up, a two month advance to an unimpressive 1.40 reading.

Then, instead of continuing to build up plus 1.0 readings as had occurred following 1962 and 1966, the DSIR in September, 1970, dropped to .96. October saw a reading of .80. November continued to provide under 1.0 readings, with a .98 showing for that month. And the latest figure, the one for December, 1970, was a real shocker. Bill Gordon just sent me a note saying that due to greatly increased volume in the 30 Dow stocks, the December DSIR reading came to a .48.

I checked back through my records and found that the December .48 figure was the second lowest figure in the 39 year history of the DSIR. The only lower figure was the .37 of July, 1933. The only comparable recent figures were the .53 reading of July, 1968, and the .58 of November, 1969 and the .55 and .53 of January and February, 1970.

Conclusion: Unlike the action following the 1962 and 1966 collapses, the 1969-70 market cave-in produced no major build-up in the DSIR. Despite this the Dow Industrials have succeeded in rallying over 200 points from their 631 low of May, 1970. Thus we have witnessed a major rally in a primary bear market, a rally which has failed to develop any real technical strength in the Dow short position. Because of this and because this is a rally in a bear market, I feel that the market is now on the most tenuous of grounds. It seems to me that the historically low figure of .48 given by the DSIR in December, 1970, should be taken as a very definite warning.

To the majority of my subscribers, the warning is superfluous, since we do not play bear market rallies large or small. To newer subscribers and to those who have taken speculative positions, I would be most wary of the market as 1971 enters. The DSIR has been a most reliable indicator over the years, I would take a low reading as serious even during a bull market. During a bear market as now, I would take the current status of the DSIR very, very seriously.

ADVANCE-DECLINE RATIO: I thought that in the first Letter of the New Year it would be appropriate to show this chart of the Dow Industrials and the A-D ratio going back to 1919. This is a unique semi-annual chart (page 5) of the Dow and the A-D ratio (each bar on the chart represents a six-month high-low range for the Dow and for the A-D ratio), and as far as I know there is no other chart like this being kept anywhere. The chart was shown once before in Letter 462.

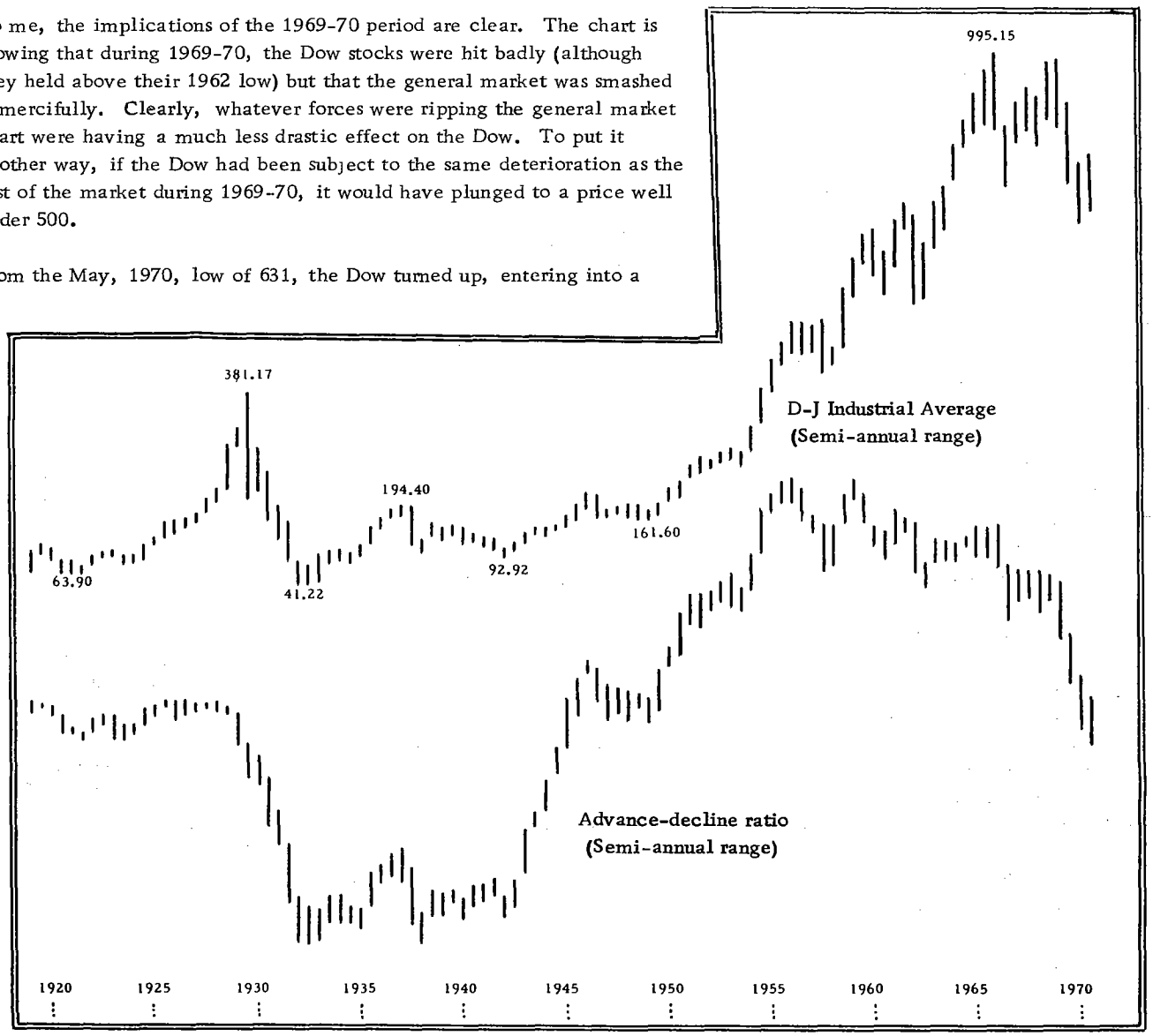
What fascinates me is the discrepency between the high-grade stocks as represented by the Dow and the rest of the market as represented by the A-D ratio. Note that the A-D ratio made a double-top during the 1956-59 period. This area represented the area of greatest "advance strength" in the broad market (as gauged by the advancing or declining tendencies of all issues listed on the N.Y.S.E.).

During the period of 1959 to 1968 it is notable that the A-D ratio formed a series of descending tops and bottoms, even though the Dow continued to form a pattern of rising tops and bottoms during the same period. Nevertheless, the steepness of the decline of the A-D ratio during 1959-68 was not too severe.

The primary bear market began in February, 1966, and I wrote after that to the effect that we were ultimately going into a slide or collapse which would dwarf anything seen since 1949. During 1969-70 the collapse began, and here we see the Dow during those two years plunging within 100 points of its 1962 low. During the same period the A-D ratio broke out of its shallower declining trend and plunged sickeningly below its 1946-49 base. The collapse of the A-D ratio during this period has no parallel except the 1929-32 period on the chart.

To me, the implications of the 1969-70 period are clear. The chart is showing that during 1969-70, the Dow stocks were hit badly (although they held above their 1962 low) but that the general market was smashed unmercifully. Clearly, whatever forces were ripping the general market apart were having a much less drastic effect on the Dow. To put it another way, if the Dow had been subject to the same deterioration as the rest of the market during 1969-70, it would have plunged to a price well under 500.

From the May, 1970, low of 631, the Dow turned up, entering into a



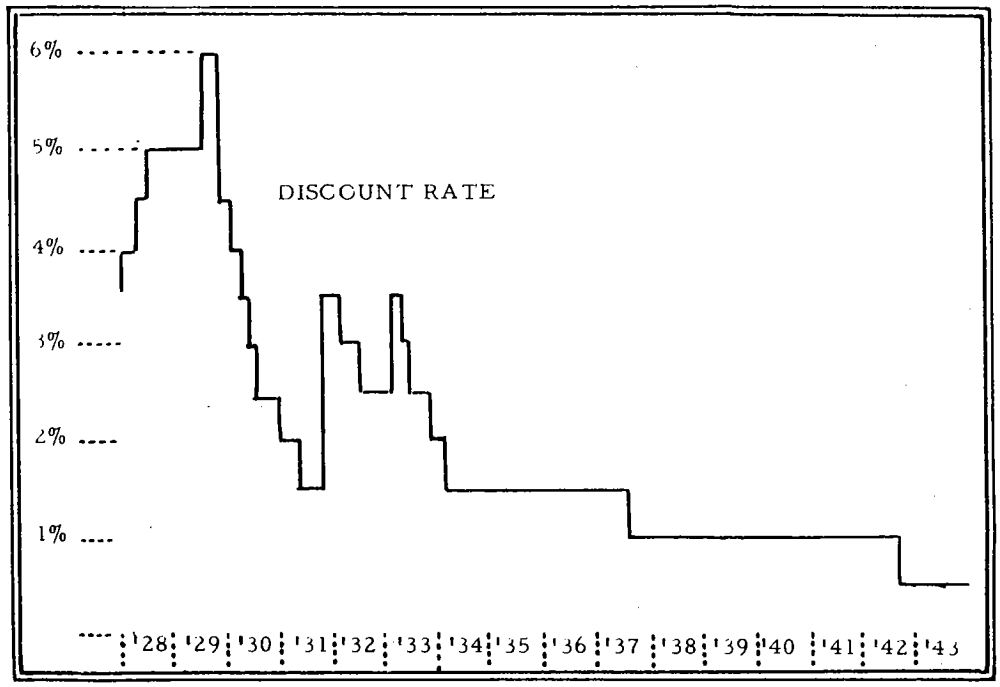
major correction or retracement. The A-D ratio continued to sink to a July low, then turned up with the Dow. As of this writing, the recovery in the Dow has been of major proportions with this Index already having regained better than half of its 1969-70 losses. But the recovery in the rest of the market, as gauged by the A-D ratio, has just gotten off the ground.

In the face of mounting debt and inflation, investors have poured money into the Dow stocks in the hope that these blue-chip vehicles will be able to show increasing profits despite adverse economic conditions and drastic inflation. The same type of thinking can be seen in the descent of the Confidence Index, which shows that money is moving into the highest-grade bonds while forsaking the lesser grade issues.

In the period ahead I foresee another sweeping decline which will subject all stocks to the pressures of the bear market with an intensity which will be almost unbelievable. So far, the reluctance of the high-grade Dow issues to collapse has exerted a definite aura of confidence over the market, even during the worst period of the 1969-70 decline. In fact, I wrote repeatedly that at no time during 1969-70 did actual panic overtake Wall Street. I do not think this type of confidence is fated to last. Nor do I think that the Dow stocks are fated to "shine" through the latter stages of this bear market.

Ultimately, I expect to see a period when the descent of the Dow stocks will be of shocking proportions, along with the rest of the market, and this period will serve to bring the two indicators on this chart into gear on the downside. At that time, there will be no confidence at all, and the brakes exerted by the Dow stocks on the downside will be off. That should correspond with the total cave-in of the cult of equity on Wall Street, and during that late descent the bear market will be going through its final throes. I expect economic, social and political conditions to be near-chaotic during the final decline.

During that period, all Government manipulations will come to naught, the massive debt monster will have collapsed, and the ills of a quarter of a century of monetary dreaming and economic hypocracy will emerge like a giant iceburg suddenly rising out of the sea.



MISCONCEPTIONS: One of the great misconceptions is that the Government can make business good merely by manipulating the money supply and the money rates. During a primary bull market, there is little doubt but that the Government can spur the economy by various monetary techniques. But during a bear market, as a previous generation found out, the Government is as helpless as anyone else when it comes to reversing the primary trend.

Most people don't realize what actually happened during 1929. During the 1920's the Government had actually reduced the national debt from around $20 billion in the early '20's to $16 billion in 1929. In contrast, today the national debt keeps sky-rocketing, building bigger and bigger problems into the economy, forcing interest rates up and driving up the yearly interest charges on the national debt. From this standpoint, the nation was far healthier in 1929 than it is today with the current almost $400 billion in debt.

December 24, 1930 (Wednesday)

NEW YORK — As a constructive step to "help the recovery of business and industry," the New York Federal Reserve today reduced its rediscount rate to 2 per cent, the lowest in the history of the system.

Nevertheless, as the crash of 1929 signalled in the great business contraction, the Federal Reserve started reducing the discount rate as now. From 6% in 1929 (see accompanying chart), the Fed reduced the rate no less than seven times to the 1931 rate of 1.5%. To dramatize this situation, I include a little clip which a subscriber has been kind enough to send regarding the 1930 picture.

As the gold problem became acute, the discount rate was raised again during 1932 and '33. Then with the devaluation in 1933, the discount rate was again reduced in the face of the mounting depression. By 1943 the discount rate was down to .5%. Only the advent of World War II turned the picture into one of boom and expanding business. The long series of discount rate reductions had been meaningless. Money was cheap, but nobody had the confidence (or the credit) to use it.

If confidence starts evaporating during this bear market, Mr. Burns can give money away and the consumers and the corporations won't know what to do with it. And that's what I have to say about money as the New Year begins.

CONSUMER: Arthur Okun (LBJ's top economist) kept a "Discomfort Index" which he considered a good gauge of the happiness or discomfort of consumers. The index is merely the total of the unemployment rate and the consumer price-rise rate. The Wall Street Journal printed these figures from the index on January 4. They estimated that the Discomfort Index is now "at least 10%--the highest since 1951." I estimate that it could be nearer 12%. All of which explains why consumers are not buying their heads off as Mr. Nixon so devoutly wishes.

Year	*Index*	*Year*	*Index*
1951	11.3%	1961	7.8%
1953	3.7%	1963	6.9%
1955	4.1%	1965	6.2%
1957	7.8%	1967	6.6%
1959	6.3%	1969	8.9%